

DOCKET SECTION

VP/CW-RT-1

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BEFORE THE
POSTAL RATE COMMISSION
WASHINGTON D.C. 20268-0001

POSTAL RATE AND FEE CHANGES, 1997)

Docket No. R97-1

Rebuttal Testimony of

DR. JOHN HALDI

on Behalf of

VAL-PAK DIRECT MARKETING SYSTEMS, INC.,
VAL-PAK DEALERS' ASSOCIATION, INC., AND
CAROL WRIGHT PROMOTIONS, INC.

William J. Olson
John S. Miles
Alan Woll
John F. Callender, Jr.
WILLIAM J. OLSON, P.C.
8180 Greensboro Dr., Suite 1070
McLean, Virginia 22102-3823
(703) 356-5070

Counsel for Val-Pak Direct
Marketing Systems, Inc.,
Val-Pak Dealers' Association, Inc.,
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1

AUTOBIOGRAPHICAL SKETCH

2

Please *see* VP/CW-T-1, pp. 1-2, Tr. 27/15040-41.

3

I. PURPOSE OF TESTIMONY

4

This testimony is divided into two distinct parts.

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Part I critiques witness Chown's (NAA-T-1) proposed method of rearranging attributable costs for purposes of assigning institutional costs and explains why that method should not be used or adopted by the Commission.

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Part II critiques certain aspects of the testimony by witness Clifton (ABA/NAA-T-1), in particular his unsupported assertions concerning cross-subsidy of Standard A Mail, as well as his unfounded and unjustified proposal to change the coverages on First-Class and Standard A Mail.

1 **II. WITNESS CHOWN'S PROPOSED REARRANGEMENT**
2 **OF ATTRIBUTABLE COSTS**

3 **Description of Chown's Proposal**

4 Witness Chown, in her direct testimony, NAA-T-1, proposes a
5 "rearrangement" of attributable costs between subclasses of mail, solely for
6 purposes of assigning institutional costs. Her rearrangement differs so
7 substantially from actual attributable costs that it justifiably can be
8 described as dramatic. Table 1 compares actual attributable costs with her
9 rearrangement of those costs, which her testimony calls "weighted
10 attributable costs."

11 It is worth noting that witness Chown's methodology does not change
12 the overall level of attribution. Perhaps the easiest way to visualize this
13 aspect of her proposal is to observe that the totals shown at the bottom of
14 columns 1 and 2 of Table 1 are exactly equal. At the same time, the
15 individual amounts shown on each row of Table 1 differ substantially, as
16 indicated by the percentages in column 3, which vary drastically from 27
17 percent to 210 percent.

18 The methodology used to develop the amounts shown in column 2 is
19 described in witness Chown's testimony, and need not be repeated here.
20 Suffice it to say that under witness Chown's methodology, the total of her
21 "weighted attributable costs" will always equal total actual attributable costs.

1 Consequently, in my opinion, it is appropriate to describe her methodology as
2 a rearranging of attributable costs. Witness Chown recommends that these
3 rearranged attributable costs be used as the basis for developing the
4 coverages used to assign all institutional costs to each class and subclass of
5 mail.¹ Under her scheme, institutional costs thus assigned would be added to
6 actual attributable costs, which sum would become the basis of target
7 revenues for each subclass.

¹ Tr. 25/13381.

TABLE 1

Actual and Weighted Attributable Costs by Function
Test Year After Rates
(000)

	Actual Attributable Costs (1)	Witness Chown's Weighted Attributable Costs (2)	Weighted as a Percent of Actual (3)
Mail Processing	\$17,184,862	\$9,645,588	56.1%
Window Service	1,400,548	2,751,959	196.5%
Transportation	3,808,826	1,044,978	27.4%
Delivery	9,938,214	20,873,147	210.0%
Other	1,983,222	0	0%
Total	\$34,315,672	\$34,315,672	100.0%

Sources: Column 1, Exhibit NAA-1B, p. 1.
Column 2, Exhibit NAA-1D.

Witness Chown's Weighted Attributable Costs

Witness Chown's weighted attributable costs are derived from the institutional costs that she considers to be "identifiable" with four functions: window service, mail processing, transportation, and delivery. Institutional costs which are not "identifiable" with any of these four functions are termed "system-wide" institutional costs. The actual attributable costs in each of witness Chown's four functions include both direct and indirect (*i.e.*, piggybacked) costs, and her "identifiable" institutional costs include non-attributed direct and indirect costs. If all direct costs in any one of these functions were 100 percent attributable, and the function in question also had no "identifiable" institutional costs whatsoever,² then under witness Chown's methodology actual and weighted attributable costs would be identical. None of the four functions has 100 percent attributable costs, but the higher the level of attribution, the lower the factor by which the function is weighted. Conversely, the lower the level of attribution, the greater the weight that is assigned.

² Under witness Chown's methodology, attributable costs within each function include indirect piggybacked attributable costs, and her "identifiable" institutional costs include institutional costs associated with piggybacked costs. Thus, even if mail processing is treated as 100 percent attributable, the indirect costs that are piggybacked onto mail processing could give rise to "identifiable" institutional costs.

The Assignment of Institutional Costs

Witness Chown proposes “that the Commission assign total institutional costs” — that is, the sum of “identifiable” and “system-wide” institutional costs — “to subclasses of mail based upon the factors in the Act using actual attributable costs.”³ She further proposes “that the Commission continue to apply its judgmental assessment of the factors under Section 3622(b) of the Act when determining institutional cost assignments.”⁴ At the same time, she is “not proposing any specific assignment of institutional costs to each subclass of mail” nor is she “proposing any specific ‘shift’ of institutional costs from one subclass to another.”⁵

**Witness Chown Builds Her Judgment on
Rate-Making Criteria into the Basis
of Institutional Cost Assignments**

The critical question that naturally arises is: what result does witness Chown hope to obtain from her proposal, since she declines to indicate how institutional costs should in fact be assigned? In order to analyze this question, it is useful to explore two “extreme” hypotheticals.

First, let us suppose that the Commission adopted witness Chown’s weighted attributable costs, but after due consideration it decided to retain

³ Tr. 25/13381 (emphasis in original).

⁴ Tr. 25/13382.

⁵ Tr. 25/13381.

1 the Postal Service's proposed contributions to institutional costs from each
2 class and subclass of mail. Clearly, as witness Chown herself points out, the
3 mark-ups on weighted attributable cost would need to be quite different, and
4 the Commission would have to alter, perhaps dramatically, the way it
5 interprets and applies the various non-cost factors of the Act in order to
6 arrive at and justify the new mark-ups. Although witness Chown
7 acknowledges that use of her weighted attributable costs does not preclude
8 the possibility of this outcome, it clearly is not her desired result.

9 As our second hypothetical, let us suppose that the Commission were
10 to interpret the non-cost factors of the Act in the same way as the Postal
11 Service has in its filing, and therefore apply the same mark-ups that the
12 Postal Service has proposed to witness Chown's weighted attributable costs.
13 Under this hypothetical, it is clear that the institutional costs assigned to
14 some subclasses of mail would be dramatically different.⁶ Concerned parties
15 would rightly ask what in witness Chown's methodology has caused such
16 altered outcomes. The answer can be viewed in one of two ways. Either
17 witness Chown's methodology has implicitly added a new rate-making
18 criterion,⁷ or it has implicitly given extremely heavy and unprecedented

⁶ Tr. 25/13421, ll. 7-8.

⁷ Witness Chown does not explicitly formulate any such criterion, but it would embody her repeated desire to "reflect the benefit each class receives from [identifiable] institutional costs." Tr. 25/13421, ll. 23-24. In fact, witness Chown explicitly denies that her methodology adds a new criterion to the Act. Tr. 25/13424, ll. 18-19.

1 weight to her particular interpretation of one of the existing statutory
2 criteria.

3 To the extent that witness Chown's methodology can be understood as
4 implicitly adding a new non-cost criterion to Section 3622(b), it clearly is
5 inappropriate and must be rejected as violative of the Act. Let us therefore
6 examine, in light of the existing criteria, her methodology along with the
7 following explanatory statement which she appeared to offer as the essential
8 motivation for her change.⁸

9 I think it is unfair to ask people with high mail processing and
10 transportation costs to contribute large amounts to the
11 institutional costs of the delivery function.

12 In focusing on "fairness," witness Chown's methodology is clearly
13 centered on her interpretation of criterion 1, fairness and equity. In my
14 opinion, her methodology would place unprecedented and undue emphasis on
15 her interpretation of criterion 1, even before the Commission begins its
16 analysis and application of the non-cost criteria of the Act.

17 Assertions to the contrary notwithstanding, witness Chown's
18 methodology and her rearrangement of attributable costs do not leave
19 application of the non-cost criteria of the Act to the Commission's unfettered
20 discretion. Rather, she applies her narrow spin on criterion 1 before the
21 Commission even begins to examine how institutional costs ought to be

⁸ Tr. 25/13430, ll. 17-19.

1 assigned. Witness Chown does not say whether criterion 1 would or should
2 also get a second round of application in determining coverage factors. She
3 appears to view “fairness” as though it could have no meaning or application
4 other than the one she attributes to it — the identification of institutional
5 costs with certain subclasses of mail. For example, if it were to rearrange
6 attributable costs in a way that reflects her perception of what is fair and
7 unfair, the Commission would have to lean over backwards to give
8 reasonable consideration to criterion 6, degree of mailer preparation, which
9 heavily favors not loading institutional costs on those mailers who enter
10 highly prepared ECR mail, often at DDUUs.

11 In sum, while ostensibly leaving undiminished the Commission’s
12 ultimate discretion to exercise its judgment on institutional cost assignments,
13 witness Chown’s proposed approach builds a large judgmental component of
14 its own into the basis she would have the Commission use — namely, her
15 weighted attributable costs. Witness Chown’s proposed approach
16 undoubtedly is meant to exercise a prior influence on the Commission’s
17 judgments, in line with her personal view of what is fair and equitable.
18 Should the Commission opt to use her rearranged attributable costs, it would
19 be forced either to yield, at least partially, to her personal standards of
20 fairness, or else it would have to revamp totally the manner in which it
21 interprets and applies the non-cost factors of the Act.

**Witness Chown's Methodology Would
Introduce a Middle Tier of Costs
Into the Rate-Setting Process**

By witness Chown's own admission, she lacks any causal basis by which her "identifiable" institutional costs can be attributed to any subclass of mail. She is of course aware that at one time a lower court first mandated, and the Supreme Court later rejected, the following "three-tier" method for distributing costs: (i) first, the Commission must attribute to each class of mail all costs "through variability theory as well as through other reasonable inferences of causation to be the consequence of providing the service"; (ii) the Commission "must then distribute among the mail classes and services that significant portion of all remaining costs of the Postal Service that may reasonably be assigned to each on the basis of best available cost-of-service estimates"; and (iii) finally, "the residuum of costs is subject to discretionary allocation in accord with the noncost factors set forth in the Act."⁹ Despite rejection of the middle tier by the Supreme Court decision, it would appear that witness Chown nevertheless feels strongly that the Commission should use a methodology which ensures that each subclass somehow bears responsibility for its "fair share" of her "identifiable" institutional costs, which in her view can be reasonably assigned by

⁹ See Nat. Ass'n of Greeting Card Publishers v. U.S. Postal Service, 569 F.2d 570, 589 (D.C. Cir., 1976) (emphasis added), mandating the "three-tier" method. This methodology was disapproved by the Supreme Court in NAGCP v. U.S. Postal Service, 462 US 810 (1983).

1 weighting the attributable costs of each subclass on the basis of her **cost-of-**
2 **service estimates.** Her “weighted attributable costs” can thus be viewed as
3 *a clever, thinly-disguised effort to reinstitute the type of approach rejected by*
4 *the Supreme Court’s decision, and have the Commission take into account a*
5 *middle tier of institutional costs by mechanistically linking her “identifiable”*
6 *institutional costs with each subclass of mail.*

7 **Witness Chown’s Classification of**
8 **Institutional Costs Ignores Incremental Costs**
9 **and Improperly Treats “System Related”**
10 **Institutional Costs**

11 At page 8 of her testimony, NAA-T-1, witness Chown defines
12 institutional costs specifically identified with each function as “identifiable”
13 institutional costs, but in addition to these “there is still a large pool of
14 institutional costs that cannot be specifically associated with any particular
15 function,” which she refers to as “system-wide” institutional costs. Exhibit
16 NAA-1C shows her “identifiable” institutional costs as \$18,261,239,000,
17 while total institutional costs shown in Exhibit NAA-1A, p. 5, amount to
18 \$26,997,063,000. Her dichotomy thus breaks down institutional costs as
19 follows (thousands):

1	Identifiable	\$18,261,239
2	System-wide	<u>8,735,824</u>
3	Total	\$26,997,063

4 Witness Chown's dichotomy ignores totally the fact that in this docket
5 the Postal Service presents estimates of both volume-variable and
6 incremental costs.¹⁰ For purposes of her testimony, she equates volume-
7 variable costs with attributable costs. Under this approach, which she
8 develops in her testimony and exhibits, "identifiable" institutional costs¹¹
9 must therefore include some \$2.8 billion of incremental costs.¹²

10 Witness Chown's failure to recognize incremental costs as a special
11 subset of non-volume variable costs and explain the extent to which they are
12 either "identifiable" or "system-wide" is a glaring omission in and of itself.
13 By definition, incremental costs are identified with specific subclasses of
14 mail, along with witness Chown's four stated functions. When she includes
15 incremental costs among her "identifiable" institutional costs, she needs to
16 explain why an incremental cost that is specific to one subclass should

¹⁰ USPS-T-30.

¹¹ Attributable costs have heretofore been based on causality (*i.e.*, establishing a causal nexus between costs and a subclass of mail), and have included both volume variable and specific fixed costs. Now that the Postal Service has made a complete presentation of incremental costs, the Commission will have to decide whether attributable costs will be based on incremental or volume-variable costs.

¹² Witness Takis, USPS-T-41, estimates that in TYAR incremental costs exceed attributable costs by approximately 8.2 percent.

1 increase her weighted attributable costs uniformly for all subclasses, rather
2 than being restricted to the one subclass to which it explicitly pertains, based
3 on an incremental cost analysis.

4 Let me provide one example to illustrate the point. A substantial
5 portion of the costs of the Eagle Network are incremental, but not volume-
6 variable. According to the testimony of witness Takis, USPS-T-41, these
7 costs are clearly identified with Express Mail. Under witness Chown's
8 methodology, though, all institutional costs that are "identifiable" with
9 transportation would increase the weighting given to transportation costs.
10 Any subclass of mail that has low density and has a large share of
11 transportation costs attributed to it, such as Parcel Post, would also have its
12 weighted attributable cost saddled with a share of the incremental costs of
13 the Eagle Network. A similar result would obtain with all other incremental
14 costs that are included in her "identifiable" institutional costs. That is,
15 instead of incremental costs being singled out and expressly assigned to each
16 individual class of mail to which they pertain, witness Chown's methodology
17 would obscure the direct one-to-one relationship and, when determining her
18 weights, would cause incremental costs to be spread to subclasses to which
19 there is no causal link.

20 Yet another problem with witness Chown's methodology is that she
21 would have "the Commission assign total institutional costs to subclasses of
22 mail based upon the factors in the Act using weighted attributable costs,

1 rather than actual attributable costs.”¹¹ By using weights derived from her
2 “identifiable” institutional costs, she claims that her weighted attributable
3 costs are “a better measure of how each subclass of mail benefits from
4 institutional effort.”¹² At no point, however, does she make any effort to
5 explain why her weighted attributable costs are a better measure of how each
6 subclass benefits from **system-wide institutional costs**. The reason such
7 an explanation is lacking, of course, is that no explanation exists. System-
8 wide institutional costs cannot be linked to any specific function, nor to any
9 class of mail. It is entirely inappropriate to imply that witness Chown’s
10 weighted costs are a better measure than actual costs of how each subclass
11 benefits from system-wide effort, because no basis exists for any such
12 statement, or for the way she treats “system-wide” institutional costs.

13 **Witness Chown’s Methodology**
14 **Lacks Economic Foundation**

15 As noted previously, witness Chown’s weights for each function are
16 inversely proportional to the percentage of costs which are attributed. The
17 delivery function, for example, has a low level of attribution, hence it receives
18 a very large weight. Her weighted delivery costs are 210 percent of actual
19 delivery cost, as shown in Table 1, column 3. Conversely, mail processing

¹¹ Tr. 25/13381 (emphasis in original).

¹² Tr. 25/13384.

1 has a rather high level of attribution, hence witness Chown's weighted
2 attributable costs are only 56.1 percent of actual attributable costs.

3 Since witness Chown does not say how the Commission should apply
4 the non-cost factors of the Act to her weighted attributable costs, she claims
5 that her methodology would not preordain any specific outcome. However,
6 unless the Commission were somehow able to find a way to counter-balance
7 the profound effect of witness Chown's weighting factors when setting
8 coverages and markups, it seems evident that subclasses which consume
9 large amounts of mail processing and transportation services would see a
10 significant reduction in their required contribution to institutional costs.
11 Similarly, subclasses which consume little or even no mail processing and
12 transportation would see a substantial increase in their required
13 contribution to institutional costs. In light of witness Chown's strong
14 explanation concerning what she subjectively regards as fair, that doubtless
15 is her desired result.

16 At the subclass level, witness Chown's weighting methodology is more
17 than faintly reminiscent of the Efficient Component Pricing paradigm that is
18 sometimes invoked with respect to rate design for individual rate categories.
19 That is, it calls for large mark-ups on the delivery function, with reduced
20 mark-ups on mail processing and transportation costs. The Efficient
21 Component Pricing paradigm is increasingly inappropriate for the changing
22 competitive environment in which the Postal Service operates. The

1 Commission and the Postal Service both need to be able to take into account
2 unfolding developments, ranging from alternate delivery of hard copy to
3 electronic funds transfer, the increasing use of toll-free telephone numbers,
4 and the Internet.

5 An analogy from the printing industry (which supplies the Postal
6 Service with a large volume of mail) may help illustrate the economic effect of
7 witness Chown's methodology. Suppose a firm has a full-service
8 establishment which, of course, is centered around the printing function.
9 Customer A needs only stationery with a simple letterhead. Customer B, by
10 contrast, needs a small booklet that requires design, layout, typesetting,
11 printing, folding, collating, and binding. If one were to apply witness
12 Chown's methodology, recovery of the firm's general administrative and
13 overhead costs should be concentrated by placing a high mark-up on one
14 function that is common to all jobs (presumably printing), with little mark-up
15 or operating profit derived from those functions used only by some customers
16 (*e.g.*, design, layout, typesetting, folding, collating, and binding). The
17 premise, presumably, would be that it is not fair to earn much profit from
18 those customers who require and use the full range of services offered by the
19 firm.

1 **Conclusion**

2 In summary, I suggest that the Commission reject use of witness
3 Chown's proposed rearrangement of attributable costs because:

- 4 • the approach to institutional cost assignment proposed by
5 witness Chown unjustifiably and yet on a permanent basis
6 builds her personal judgments on fairness and equity into the
7 mechanics of rate design;
- 8 • the narrow conception of fairness and equity underlying the
9 above personal judgments is itself flawed;
- 10 • the proposed classification of "identifiable" institutional costs
11 deals with incremental costs in an entirely inappropriate
12 manner; and
- 13 • the proposal to change the basis for assigning system-wide
14 institutional costs has no foundation.

15 I cannot think of any economic justification to support the mechanistic
16 application of weighting factors such as those advocated by witness Chown.
17 Moreover, in my opinion, the use of such weights would reflect bad
18 economics, and set an undesirable precedent.

**III. WITNESS CLIFTON'S PROPOSAL TO REDUCE RATES
FOR THE SECOND AND THIRD OUNCE OF
WORKSHARED FIRST-CLASS MAIL AND
INCREASE RATES FOR STANDARD A MAIL
BY A CORRESPONDING AMOUNT**

Description of Clifton's Proposal

Witness Clifton, in his direct testimony, ABA/NAA-T-1, pp. 11-16, Tr. 21/10829-34, proposes to reduce the rate for the second and third ounce of First-Class workshared letters from 23 to 12 cents per ounce, and compensate for any loss of revenues through an increase in rates for Standard A Mail by a corresponding amount. Witness Clifton does not call attention to one immediate effect of this proposal to reduce revenues in First-Class and increase them in Standard A. Namely, it would reduce the coverage on First-Class Mail and increase the coverage on Standard A Mail. Witness Clifton does not indicate how he would split his proposed increase between the Regular and ECR subclasses of Standard A Mail. He does acknowledge that under the Revenue Forgone Reform Act, an increase in the mark-up on commercial rate Standard A Mail would cause the mark-up on nonprofit Standard A Mail to increase in tandem (by one-half).

Witness Clifton attempts to justify his proposal by asserting that (i) the marginal cost associated with handling additional ounces of First-Class workshared letter mail is low, (ii) at 23 cents per ounce the implicit coverage on the second and third ounce of workshared letters is 920 percent,

1 and (iii) such a high implicit cost coverage must mean that mail in some
2 other class is being cross-subsidized. Witness Clifton selects Standard A
3 Mail, especially the lack of a rate increase in the second and third ounce
4 rates, as the target of his cross-subsidization charges.

5 **Position of This Testimony**

6 I do not take issue with witness Clifton's position that at 23 cents per
7 ounce (or \$3.68 per pound) the rate for additional ounces of First-Class Mail
8 seems generally high in relation to the Postal Service's cost of handling extra
9 weight. I do, however, take issue with his assertion that a high implicit
10 coverage is, *per se*, an indication of cross-subsidy to any other class of mail, as
11 well as his assertion that any subclass of, or rate category within, Standard A
12 Mail is currently being or will be subsidized under the Postal Service's
13 proposed rates. Furthermore, his proposed reduction in cost coverage for
14 First-Class Mail is neither properly analyzed nor adequately justified.

15 **The Weight-Cost Relationship** 16 **of First-Class Mail**

17 This docket is not the first case to recognize, nor is witness Clifton the
18 first person to testify, that within First-Class Mail the decremental rate that
19 is charged for each additional ounce beyond the first ounce appears excessive
20 in relationship to the Postal Service's cost of handling extra weight.

1 Although the Postal Service has not submitted a reliable study concerning
2 the weight-cost relationship for First-Class Mail, considerable evidence
3 suggests that the current rate of 23 cents per ounce is substantially above the
4 marginal cost incurred in handling additional weight. For example, the
5 Postal Service's proposed pound rates for the Standard A Regular and ECR
6 subclasses are, respectively, \$0.65 and \$0.53. Each proposed Standard A
7 pound rate is a small fraction, less than 20 percent, of the \$3.68 pound rate
8 (\$0.23 per ounce) both currently charged and proposed for First-Class Mail.

9 As another example, the minimum rate for up to two pounds of
10 Priority Mail is currently \$3.00 (proposed by the Postal Service to increase to
11 \$3.20). If this minimum rate were to be broken down into per-piece and per-
12 pound components, the weight component would be less than \$1.50 per
13 pound, and at this rate the Postal Service appears to earn a substantial profit
14 on Priority Mail; *i.e.*, for this component of First-Class Mail the average cost
15 appears to be well under \$1.50 per pound. Also, the current incremental
16 unzoned rate for a 3-, 4- and 5-pound Priority Mail package is \$1.00
17 (proposed by the Postal Service to increase to about \$1.10), which is well
18 below the \$3.68 per-pound rate charged for extra ounces of First-Class Mail.

19 As a third example, the coverage for all First-Class flats, which have
20 an average weight of 3.3 ounces, amounts to 256 percent, significantly above
21 the average coverage for First-Class Mail. This is yet another indication that

1 the decremental rate for extra ounces exceeds the incremental cost arising
2 from additional weight.¹³

3 Admittedly, witness Clifton's testimony concerning the rate for extra
4 ounces of First-Class Mail raises an interesting issue for the Commission's
5 consideration. Nevertheless, there are several other ways to deal with the
6 issue other than his narrowly-crafted proposal to limit rate relief to the
7 second and third ounce of workshared letters. Although the record does not
8 support any definitive proposal, a sharply-focused, piecemeal proposal such
9 as that advanced by witness Clifton can benefit by having some benchmarks
10 against which it can be evaluated. For example, as a more comprehensive
11 initiative, he could have proposed a 1-cent increase in the rate proposed by
12 the Postal Service for an under one-ounce First-Class letter (to 34 cents),
13 coupled with an across-the-board decrease of 4 or 5 cents in the rate for all
14 additional ounces (*e.g.*, to 18 or 19 cents per ounce). Such an approach to the
15 underlying issue raised by witness Clifton is clearly broader, and perhaps
16 somewhat fairer to all First-Class mailers, than his proposal.

17 A slight variation might have been to increase the basic rate for a
18 First-Class letter by 2 cents (*i.e.*, to 35 cents), with the understanding that up
19 to two ounces could be mailed for that rate, coupled with an incremental rate
20 that would be applicable for each additional two ounces. The rate for

¹³ See NDMS-T-1, p. 34, Tr. 24/12907.

1 additional weight might need to be increased from 23 cents to, say, 30 cents.
2 However, since that rate would cover each additional two-ounce increment,
3 the result would be a decrease for heavier-weight pieces. For example, at the
4 Postal Service's proposed rates of 33 cents for the first ounce and 23 cents for
5 each additional ounce, 3-ounce and 5-ounce pieces would pay \$0.79 and
6 \$1.25, respectively. At 35 cents for the first two ounces, plus 30 cents for
7 each additional two ounces, the rate for 3-ounce and 5-ounce pieces would be
8 \$0.65 and \$0.95, which is somewhat less than the Postal Service's proposed
9 rates.¹⁴

10 Alternatively, within the rate category of workshared First-Class Mail,
11 witness Clifton might have proposed a rate design that shippers sometimes
12 refer to as "hundredweight" pricing. Under this approach, the postage for
13 workshared mail, which is always entered in bulk at a Postal Service
14 acceptance unit, would consist of a fixed amount per piece, plus a pound rate
15 applied to the total weight of the mailing.¹⁵ Hundredweight pricing does not
16 involve any rate averaging for additional weight, even 1-ounce increments.
17 Instead, under hundredweight pricing, each additional insert increases a
18 mailer's weight and postage, and mailers always have an incentive to

¹⁴ Witness Clifton registers strong objection to the fact that rates within Standard A are averaged over the first 3.3 ounces. By averaging rates over two-ounce increments, the structure for First-Class rates would become more like that for Standard A. This, arguably, would also simplify First-Class rates.

¹⁵ This is the way postage is computed for Standard A bulk mail that exceeds the breakpoint of 3.3 ounces per piece.

1 restrain the weight of their mail at the margin. At the same time, even
2 without any reduction in nominal rates, hundredweight pricing would reduce
3 the actual postage paid by worksharing mailers. This can be readily
4 illustrated using the proposed rates for single piece mail (*i.e.*, 33 cents for the
5 first ounce plus 23 cents for each additional ounce). Under hundredweight
6 pricing, the rate would be 10 cents per piece plus \$3.68 per pound, subject to
7 a minimum rate that averages 33 cents per piece.¹⁶

8 Using the preceding assumptions, consider the rate for a mailing of
9 1,600 pieces, each weighing 1.5 ounces. Under proposed rates, each piece
10 would pay 56 cents (33 + 23 cents), for a total of \$896. Under hundredweight
11 pricing, the mailer would pay 10 cents per piece, or \$160, plus 150 pounds
12 times \$3.68, or \$553, for a total of \$712. In this particular example, the total
13 postage would be 20 percent less than the single piece rate, even though the
14 rate for additional weight is \$3.68 (which is equivalent to 23 cents per
15 ounce).

16 It is not the purpose of my testimony to propose at this time any of the
17 preceding alternatives, or any other alternative for that matter, as a
18 substitute for the proposal advanced by witness Clifton. At the same time,
19 the Commission needs to recognize that mailers of 2- and 3-ounce
20 workshared letters are not the only ones that are disadvantaged by the 23

¹⁶ For simplicity, this example ignores the various presort and prebarcode discounts which would continue to be applicable to all workshared mail.

1 cent rate for each additional ounce of First-Class Mail, if it were found to be
2 excessively high. Witness Clifton's proposal ignores the needs of these
3 mailers and should be evaluated in a broader context, since its adoption
4 would likely complicate or act as a barrier to alternative changes that the
5 Commission might find equally or more desirable.

6 A piecemeal, *ad hoc* approach to the issue raised by witness Clifton
7 could wind up balkanizing the First-Class Mail rate categories. Inevitably,
8 the Commission would be called upon to grant some kind of relief to the
9 additional ounce rate for other portions of the First-Class Mail stream. If
10 such request is analyzed and presented separately, the foreseeable result
11 could be separate rates for (i) the second and third ounce of workshared letter
12 mail; (ii) the fourth through the eleventh ounce of workshared letter mail;
13 (iii) the second and third ounce of single piece letter mail; (iv) the fourth
14 through the eleventh ounce of single piece letter mail; (v) the extra ounce
15 rate for flats that weigh less than, say, 4 or 5 ounces; (vi) the extra ounce rate
16 for flats that weigh more than, say, 4 or 5 ounces; and (vii) the extra ounce
17 rate for residual, non-letter, non-flat pieces (*i.e.*, parcels).

18 **Contrary to Witness Clifton's Assertion, No Part**
19 **of Standard A Mail Receives a Cross-Subsidy**

20 In his direct testimony, witness Clifton asserts that "since the zero
21 extra-ounce charge for the second and third ounces of Standard A mail is not

1 cost-justified, the incremental extra-ounce cost of this mail is creating an
2 apparent cross-subsidy to Standard A mail from other mail classes.”¹⁷ For
3 reasons explained below, this statement is not correct.

4 The term “cross-subsidy” is a compound word. The existence of a cross-
5 subsidy implies, first of all, that some entity (which could be a group of
6 customers) is being subsidized and, second, that the subsidy is provided by
7 other ratepayers, not by taxpayers (via the government). With respect to
8 subsidy as it applies to customers, or users, of a product or service, it is
9 commonly accepted in economics that a subsidy exists when the rates paid by
10 the users do not cover the incremental costs of providing the product or
11 service.

12 When asked to define and justify the term “cross-subsidy” as used in
13 his testimony, witness Clifton cites the first edition of a text by Carlton and
14 Perloff.¹⁸ I was unable to locate a copy of this edition, but in the second
15 edition (© 1994) the Carlton and Perloff source cited by witness Clifton
16 contains the same example, accompanied by the following footnote:

17 SOURCE: Stigler and Friedland (1962). See
18 Faulhaber (1975) for a precise definition of cross-
19 subsidy.
20

¹⁷ ABA/NAA-T-1, p. 2. Tr. 21/10820.

¹⁸ Tr. 21/10915.

1 The article by Stigler and Friedland discusses the extent to which
2 regulators of the electric utility industry have been able to affect the overall
3 level of prices, as well as the rates paid by various groups of customers.¹⁹

4 This article, while interesting, is irrelevant to the issue of subsidy or cross-
5 subsidy. It never once uses or mentions the term "subsidy"; it refers to
6 another issue contained in the example discussed by Carlton and Perloff.

7 The article by Faulhaber deals with multiproduct firms that have
8 economies of joint production,²⁰ and amazingly, it flatly contradicts the
9 implicit definition of cross-subsidization offered by Carlton and Perloff, who
10 cite Faulhaber as a source.²¹ Between the contradictory positions of
11 Faulhaber and Carlton/Perloff, the careful and detailed theoretical argument
12 of Faulhaber is incomparably more authoritative than the loose, cursory
13 discussion by Carlton/Perloff, who deal in their textbook with cross-
14 subsidization as one topic among many. They clearly do not have
15 Faulhaber's in-depth theoretical expertise on the topic of cross-subsidization.
16 According to Faulhaber,

¹⁹ Stigler, George J., and Claire Friedland, "What Can Regulators Regulate? The Case of Electricity." *Journal of Law and Economics*, October 1962 (Vol. V), pp. 1-16.

²⁰ Gerald R. Faulhaber, "Cross-Subsidization: Pricing in Public Enterprises." *American Economic Review*, Vol. 65 (1975), pp. 966-77.

²¹ Carlton, Dennis and Perloff, Jeffrey, Modern Industrial Organization. Harper Collins, 1994, p. 855, lines 1-7.

1 If the provision of any commodity (or group of commodities) by a
 2 multicommodity enterprise subject to a profit constraint leads to
 3 prices for the other commodities no higher than they would pay
 4 by themselves, then the price structure is **subsidy-free**.
 5 (Emphasis in original.)

6 When the price structure is not subsidy-free, it can be said to result in
 7 **cross-subsidy** (assuming, of course, that the firm does not receive any
 8 governmental subsidy). The Faulhaber article discusses (in rigorous
 9 mathematical game-theoretic terms) conditions under which a price structure
 10 is subsidy-free. Succinctly, in order to determine that a price structure is
 11 subsidy-free, it is necessary to ascertain (i) whether products are covering
 12 their incremental costs on an individual basis, and (ii) whether various
 13 combinations or groupings of products are also covering their incremental
 14 costs when considered jointly.

15 The fact that one product has a high profit margin (or coverage, in the
 16 case of postal products) is a good indication that, insofar as that product is
 17 concerned, the price structure is **subsidy-free**. What this means is that a
 18 high coverage, or profit margin, emphatically does not in any way prove the
 19 existence of a cross-subsidy to some other product.²² The fact that various
 20 customers pay different prices for a product with the same or similar cost is
 21 not sufficient to establish the existence of cross-subsidy. Incidentally, the

²² In the course of my private consulting work, I have encountered non-
 postal products where the profit margin exceeded the 920 percent that witness
 Clifton claims for the second and third ounce of workshared First-Class workshared
 letters.

1 example in Carlton and Perloff cited by witness Clifton is neither an example
2 nor a definition of cross-subsidy.

3 **No Portion of Standard A Letters**
4 **Receives a Cross-Subsidy**

5 When asked to define the term "cross-subsidy" as used in his
6 testimony, witness Clifton's response was as follows:²³

7 Cross subsidization in this context means that Standard
8 A workshared letters are charged zero cents for the second and
9 third ounce, which is below the marginal cost of these extra
10 ounces.

11 This statement ignores totally the different rate designs of the two
12 classes. In Standard A, rates are simply averaged over the first 3.3 ounces,
13 while in First-Class rates are averaged over each ounce. Using witness
14 Clifton's approach, one could also say, with equal justification, that within
15 any one-ounce category of First-Class letter mail, $N + 0.1$ ounce letters cross-
16 subsidize $N + 0.9$ ounce letters.²⁴ Carried to its logical extreme,
17 hundredweight pricing for bulk mail would be the only way to eliminate
18 cross-subsidies, as defined by witness Clifton.²⁵

²³ Tr. 21/10896.

²⁴ The term "N" is an integer equal to 0,1,2,3,... up to the penultimate maximum weight of First-Class Mail.

²⁵ As USPS witness Moeller has already noted, "there is a certain degree of averaging within most, if not all, rate categories." DMA/USPS-T36-3. Tr. 6/2740. Within unzoned Priority Mail up to 5 pounds, rates are averaged across all zones. Although a 4-pound package to Zone 8 has a lower profit margin than one of the

1 **Witness Clifton has not Justified**
 2 **the Proposed Shift in Coverage**

3 The high coverage which witness Clifton asserts for the second and
 4 third ounce of workshared First-Class Mail constitutes a small part of the
 5 coverage for all First-Class Mail. Witness Clifton's proposal to reduce rates
 6 on the second and third ounce of workshared letters would cause a reduction
 7 in both revenues and coverage for First-Class Mail. While expressing
 8 indignation at the asserted 920 percent coverage on the second and third
 9 ounces, witness Clifton's testimony makes no effort to justify, in terms of the
 10 non-cost criteria of the Act, his proposed reduction in the coverage of First-
 11 Class Mail, nor does he bother to explain why he has not proposed offsetting
 12 increases for other components of the First-Class rate structure.²⁶

13 Similarly, in proposing to increase the cost coverage on Standard A
 14 Mail, witness Clifton ideally should review all the criteria of the Act as they
 15 apply to Standard A. At a minimum, witness Clifton should explain which of
 16 the non-cost criteria have been misapplied or misinterpreted by witness
 17 O'Hara. In the absence of such review, witness Clifton has not justified any

same weight to the local, 1, 2, 3 zone, it does not follow that the package to Zone 8 is cross-subsidized by the package delivered locally.

²⁶ If some rate categories of First-Class Mail have implicit coverages much higher than the average for all First-Class Mail, as witness Clifton asserts, then it stands to reason that the cost coverage of some rate categories within First-Class Mail must be below the average. Witness Clifton nevertheless avers that the coverage is too high on all components of First-Class Mail; see Tr. 21/10973.

1 change in coverage. It is not sufficient to say that he does not like
 2 advertising mail, or to quote surveys to that effect.²⁷

3 Conclusion

4 In sum, I wish to reiterate that I do not take issue with witness
 5 Clifton's position that the 23 cents-per-ounce rate for additional ounces of
 6 First Class Mail seems generally high in relation to the Postal Service's cost
 7 of handling extra weight. I do, however, take issue with several of the key
 8 points that he presents in the sequel of his testimony.

- 9 • High implicit cost coverage of a rate category, contrary to what
 10 witness Clifton asserts, is *per se* no indication of cross-subsidy to
 11 any other subclass or rate category. Before the issue of cross-
 12 subsidization can be raised at all, it is necessary to show that
 13 some rates fail to cover incremental costs and that subsidization
 14 exists.
- 15 • Witness Clifton does not demonstrate that any part of Standard
 16 A Mail receives a subsidy. His argument that rate averaging
 17 within the first 3.3 ounces of Standard A Mail represents a
 18 subsidization of the second and third ounce by the first ounce is
 19 academic to the point of being downright frivolous. By the same
 20 argument, any nonzero weight range in the Postal tariff
 21 structure would represent a subsidization of items near the high
 22 end of the range by items near the low end. In this regard, the
 23 usual one-ounce range is no different from any other weight
 24 range that may be chosen as convenient for rate design.
 25 Therefore, when witness Clifton singles out rate averaging
 26 within the first 3.3 ounces of Standard A Mail to compensate for
 27 his proposed reduction of First-Class additional-ounce rates, he
 28 does so in a narrowly arbitrary fashion that lacks justification.

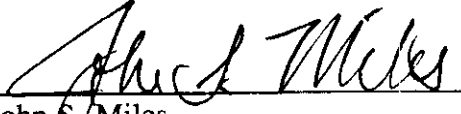
²⁷ See Answers of ABA/NAA witness Clifton to questions posed during
 hearings, p. 5.

- 1 • Witness Clifton's testimony is equally narrow and arbitrary
2 when it singles out the rate for the second and third additional-
3 ounces of First-Class workshared mail, but not the rate applying
4 to further additional ounces, as his target for particular rate
5 reductions. Linking this reduction to his proposed
6 compensatory coverage for Standard A Mail makes neither of
7 the two proposed changes less arbitrary.

8 Witness Clifton's position concerning the exceedingly high coverage of
9 the First-Class additional-ounce rate has merit, and the Commission would
10 be well advised to consider it in the broad context of a variety of options for
11 distributing considerable reductions, together with a broad range of possible
12 ways to offset the corresponding revenue loss by readjustment of First-Class
13 rates. The narrowly crafted and arbitrarily linked rate adjustment proposals
14 of witness Clifton should be rejected as unacceptable.

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document upon all participants of record in this proceeding in accordance with Section 12 of the Rules of Practice.



John S. Miles

March 9, 1998